Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

FCC No. 96-214

In the Matter of	)	
	)	
Allocation of Costs Associated with	)	CC Docket No. 96-112
Local Exchange Carrier Provision of	)	
Video Programming Services	)	

NOTICE OF PROPOSED RULEMAKING

Adopted: May 10, 1996; Released: May 10, 1996

By the Commission:

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I. INTRODUCTION

1. The Telecommunications Act of 1996 (1996 Act) became law on February 8, 1996.[1] The 1996 Act establishes an overarching goal that the Commission "provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition. . . ."[2] Consistent with this goal, the 1996 Act replaces the statutory prohibition against incumbent local exchange carrier provision of video programming directly to subscribers in its telephone service area with a new regulatory model.[3] The 1996 Act offers common carriers[4] four ways to enter and

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[1] Telecommunications Act of 1996, Pub. L. No. 104-104, 101 Stat. 56 (1996). We refer to provisions of the 1996 Act using the sections at which they will be codified.

[2] Telecommunications Act of 1996 Conference Report, S. Rep. 104-230 at 113 (Feb. 1, 1996) (*Conference Report*).

[3] *See* Cable Communications Policy Act of 1984, Pub. L. No. 98-549, § 613(b) (codified at 47 U.S.C. § 553(b)), enacting the telephone-cable cross-ownership prohibition. The prohibition did not apply "in rural areas" and could be waived by the Commission upon

compete in the video programming service marketplace. They may choose to: (1) provide transmission of video programming on a common carrier basis under Title II of the Communications Act;[5] (2) provide video programming service to subscribers through radio communication under Title III of the Communications Act;[6] (3) provide video programming service as a cable system under Title VI of the Communications Act;[7] or (4) for local exchange carriers, provide video programming service by means of an "open video system" under new Section 653 of the Communications Act.[8]

2. In this Notice of Proposed Rulemaking (Notice) we initiate a proceeding to implement these specific provisions of the 1996 Act by reexamining the Commission's rules governing how incumbent local exchange carriers allocate their costs between regulated and nonregulated activities.[9] Specifically, we seek to amend our cost allocation rules and procedures to accommodate an incumbent local exchange carrier's use of the same network facilities to provide video programming service and other competitive offerings not subject to Title II regulation, as well as telephony and other Title II offerings. The basic problem addressed in this proceeding is how to allocate common costs between the nonregulated offerings that will be introduced by incumbent local exchange carriers and the regulated services they already offer. Our current cost allocation rules were not designed for this task. Initially, we anticipate the most difficult problem we must address is how to allocate common costs associated with facilities connecting incumbent local exchange carrier switching facilities with customers' premises. We anticipate, however, that similar problems will arise concerning allocation of common costs of switching equipment and interoffice trunks. While much of the focus of this

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a "showing of good cause." *Id.* at § 613(b)(3), (4).

[4] The 1996 Act uses the term "incumbent local exchange carriers" to describe common carriers we have historically called "telephone companies." *See* 1996 Act sec. 101, § 251(h). Throughout this item we use these terms interchangeably.

[5] 1996 Act sec. 302, § 651(a)(2).

[6] *Id.* at 651(a)(1).

[7] *Id.* at § 651(a)(3).

[8] *Id.* at § 651(a)(3)-(4). Section 271(h) also permits Bell Operating Companies to offer video programming services across LATA (local access and transport area) boundaries.

[9] By nonregulated activities, we mean activities not regulated under Title II of the Communications Act. This category generally consists of: activities that have never been subject to regulation under Title II; activities subject to Title II regulation that we have preemptively deregulated; and activities subject to Title II regulation that have been deregulated at the interstate level, but not preemptively deregulated, that we decide should be classified as nonregulated activities for Title II accounting purposes. *See* 47 C.F.R. S 32.23(a).

proceeding is on provision of video programming service by incumbent local exchange carriers, we note that this is likely to be only the first major competitive service that will be provided jointly with regulated telephone service. We anticipate that other such services will follow. Thus, in the short term, video services will account for the majority of non-Title II use of the network facilities of incumbent local exchange carriers. We anticipate that in the long term, however, that a panoply of broadband-based, nonregulated services will share facilities with regulated services. We seek comment on whether and how the procedures established in this proceeding should be applied to incumbent local exchange carrier provision of video programming services and other competitive offerings by those companies.[10] In particular, we seek comment on how changes in usage over time should affect cost allocation between regulated and nonregulated activities.

II. BACKGROUND

A. The Telecommunications Act of 1996 -- Video Programming Provisions

3. Section 302 of the 1996 Act establishes a new part V (Section 651-653) of Title VI of the Communications Act of 1934 setting forth the general regulatory treatment for video programming services provided by common carriers. As stated above, the specific entry options for common carriers entering the video programming marketplace are set forth in Section 651, which provides that they may provide video programming: (1) as a common carrier under Title II; (2) through radio communications under Title III; (3) as a cable system under Title VI; or (4) if the common carriers is a local exchange carrier, as an open video system under Title VI.

4. In allowing common carriers to enter the video programming marketplace, Congress stated:

> Recognizing that there can be different strategies, services and technologies for entering video markets, the conferees agree to multiple entry options to promote competition, to encourage investment in new technologies and to maximize consumer choice of services that best meet their information and entertainment needs.[11]

The *Joint Explanatory Statement of the Committee of Conference* notes that "the conferees recognize that telephone companies need to be able to choose from among multiple video entry

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[10] Although the 1996 Act refers to the provision of video programming services by "common carriers" we are concerned with offerings of "incumbent local exchange carriers" because only the latter are subject to our rules governing the allocation of costs between regulated and nonregulated activities.

[11] *Conference Report* at 172.

options to encourage entry," and therefore systems under this section should be "allowed to tailor services to meet the unique competitive and consumer needs of individual markets."[12] The 1996 Act, thus, gives incumbent local exchange carriers broad flexibility in determining how to enter and compete in the video marketplace. Ultimately, the 1996 Act recognizes that vigorously competitive markets are the best way to serve consumers' interests.

5. The concept of open video systems presented in Section 653 creates a new framework for entering the video marketplace. Generally, Section 653 provides that, if a local exchange carrier certifies that it complies with certain non-discrimination and other requirements established by the Commission, its open video system will not be subject to regulation under Title II and will be entitled to reduced regulation under Title VI.[13] The Commission must approve or disapprove any open video system certification request within ten days of receipt.[14]

6. The 1996 Act also contains numerous other provisions that may result in common carriers providing other competitive services that may be classified as "nonregulated activities" for purposes of our Part 64 cost allocation process. This proceeding addresses methods for allocating costs between regulated activities subject to Title II and nonregulated activities including video services and other offerings that become subject to competition that will protect customers of regulated services against cost misallocations.

B. The Commission's Proceeding to Implement Open Video Systems

7. In a separate proceeding, the Commission is developing rules for open video systems.[15] In general, the *Open Video Systems Notice* seeks to determine what Commission action will best ensure that carriers meet the open video system requirements to promote Congress' goals of open interconnection, enhanced competition, streamlined regulation, diversity of programming choices, investment infrastructure and technology, and increased consumer choice.[16]

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[12] *Id.* at 177.

[13] *Id.* at § 653(a)(1), (c).

[14] *Id.* at § 653(a)(1).

[15] *See* Implementation of Section 302 of the Telecommunications Act of 1996, Open Video Systems, Telephone Company-Cable Television Cross-Ownership rules, Section 63.54-63.58, *Report and Order and Notice of Proposed Rulemaking*, CS Docket Not. 96-46, CC Docket No. 87-266 (Terminated), FCC No. 96-99 (Mar. 11, 1996) (*Open Video Systems Notice*).

[16] *Id.* at para. 4, citing Conference Report at 172, 177-78.

8. The *Open Video Systems Notice* notes that the Part 64 rules would require a telephone company seeking certification for open video systems "to segregate its cost of providing regulated telecommunications services from its cost of providing an unregulated service (i.e., the provision of video programming service over an open video system)."[17] That Notice also seeks comment on what actions or representations regarding the Part 64 process the Commission should require in the open video systems verification process.[18]

III. THE PART 64 COST ALLOCATION PROCESS

9. Part 64 of the Commission's rules governs an incumbent local exchange carrier's allocation of joint and common costs between activities regulated under Title II and nonregulated activities.[19] The Commission established these rules to protect ratepayers from bearing the costs and risks of nonregulated activities. The rules are intended to deter unreasonable cost shifting both from cost misallocations of joint and common costs and from affiliate transactions.[20]

10. The allocation of costs between regulated and nonregulated activities under Part 64 uses the accounts established in our Part 32 Uniform System of Accounts (USOA) for telecommunications companies.[21] The USOA is an historical financial accounting system that reports the results of operational and financial events in a manner that enables management, regulators, the financial community and others to assess these results within a specified

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[17] *Id.* at para. 70, citing the impendency of this proceeding.

[18] *Id.*

[19] If an expense is *joint* with respect to services A and B, the elimination of either service A or B alone will not eliminate the cost. A cost-causative relationship thus does not exist between the expense and individual services. If an expense is *common* with respect to services, a cost-causative relationship can be determined by varying the service outputs and observing the effect on total cost. An expense is *special* with respect to services if the expense is dedicated to producing only that service. For an explanation of how common costs can be attributed to individual services in a cost-causative manner, *see* Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions Vol. 1* (New York: John Wiley & Sons, 1970), Chapter 3.

[20] *See* Separation of Costs of Regulated Telephone Service from Cost of Nonregulated Activities, CC Docket No. 86-111, Report and Order, 2 FCC Rcd 1298 (1987) (*Joint Cost Order*), *modified on recon.*, 2 FCC Rcd 6283 (1987) (*Joint Cost Reconsideration Order*), *modified on further recon.*, 3 FCC Rcd 6701 (1988) (*Joint Cost Further Reconsideration Order*), *aff'd sub nom. Southwestern Bell Corp. v. FCC*, 896 F.2d 1378 (D.C. Cir. 1990).

[21] 47 U.S.C. Part 32 -- Uniform System of Accounts for Telecommunications Companies.

accounting period. The USOA reflects stable, recurring financial data kept in accordance with generally accepted accounting principles.[22]

11. Our Part 64 rules direct incumbent local exchange carriers to allocate the costs in these accounts between regulated and nonregulated activities pursuant to a hierarchy of cost apportionment methods that emphasizes direct assignment and the use of cost-causative allocation methods. Part 64 applies to "incumbent local exchange carriers" as that term is defined in the 1996 Act.[23]

12. Whenever possible, costs in each Part 32 account are to be directly assigned to either regulated or nonregulated activities. For example, the salary of a customer service representative dealing exclusively with interexchange carriers taking access services would be directly assignable to regulated activities. If costs cannot be directly assigned, they are considered common costs and placed in cost pools. These are homogeneous cost categories designed to facilitate the cost allocation process.[24]

13. The costs in each pool are then allocated between regulated and nonregulated activities using a usage-based allocation factor. Although the *Joint Cost Order*, which established the Part 64 rules, did not prescribe a specific allocation factor for each cost pool, it established guidelines for carriers selecting allocation factors based on cost-causative principles. Whenever possible, common costs are to be directly attributed based upon direct analysis of the origin of the costs themselves.[25] Common costs that cannot be directly assigned are to be attributed based on an indirect, but cost-causative linkage to another cost pool or group of cost pools for which a direct assignment or attribution is available.[26] If direct or indirect measures

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[22] 47 C.F.R. § 32.1.

[23] *See* 1996 Act sec. 101, § 251(h). We note that our rules do not require incumbent local exchange carriers subject to rate-of-return regulation that receive interstate revenues based on the average schedules prepared by the National Exchange Carrier Association to prepare cost allocation manuals. The schedules, however, are based on costs of companies that do follow the Part 64 procedures.

[24] A category of cost is generally considered "homogeneous" if it contains the costs incurred in the same way, if the facilities are used in the same way, or if the costs in the category are susceptible to the same allocation factor.

[25] For example, the distribution of customer accounting service and equipment processing expense could be directly attributed to regulated services and nonregulated activities on the basis of the number of regulated and nonregulated service orders.

[26] For example, the distribution of the time that craft employees worked on regulated services and nonregulated activities could be used to allocate their supervisors' salaries between regulated services and nonregulated activities. In this example, the craft employees'

of cost causation are not available, they are deemed "unattributable" and the cost pool is allocated using a prescribed general allocator.[27]

14. Each incumbent local exchange carrier with $100 million or more in annual operating revenues must file cost allocation manuals setting forth the carrier's methodology for allocating costs between Title II regulated and nonregulated services.[28] Each of these manuals must: (a) describe the carrier's nonregulated activities; (b) list all of the carrier's incidental activities and the justification for treating each activity as incidental;[29] (c) contain a chart showing all of the carrier's corporate affiliates; (d) describe affiliates that engage in or will engage in transactions with the carrier and the nature, terms, and frequency of such transactions; and (e) provide, for each Part 32 account, a detailed description of the cost pools to which amounts in the account will be assigned and the basis on which each cost pool will be allocated.[30] The cost allocation manuals must contain a description of the carrier's time reporting procedures.[31] In the *CAM Uniformity Order*,[32] the Bureau prescribed cost pools and allocations for ten accounts within the USOA that all incumbent local exchange carriers must use. The requirements were intended to ensure uniformity in the application of our rules among carriers and to permit more effective oversight.[33]

15. A major element of the cost allocation manuals is the cost apportionment tables. The tables generally describe the allocation process, including: the Part 32 accounts; descriptions of the cost pools; descriptions of the allocation procedures for each cost pool; and

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time would be an indirect measure of cost causation to allocate supervisors' salaries.

[27] For each subject carrier, its general allocator is the ratio of regulated to nonregulated allocations for all expenses directly assigned or directly or indirectly attributed. 47 C.F.R. § 64.901(b); *see Joint Cost Order*, 2 FCC Rcd at 1318-19 The cost of maintaining a corporation as a legal entity is an example of an unattributable cost.

[28] 47 C.F.R. § 64.903(a).

[29] "Incidental activities" include costs of nontariffed activities that are outgrowths of regulated operations totalling an amount less than one percent of a company's total revenues. *Joint Cost Order*, 2 FCC Rcd at 1308. For example, costs associated with moving cables during road repair or other construction operations would be an incidental activity.

[30] 47 C.F.R. § 64.903.

[31] *Id.*

[32] Implementation of Further Cost Allocation Uniformity, *Memorandum Opinion and Order*, 8 FCC Rcd 4664, 4665-70 (Com.Car.Bur. 1993)

[33] *Id.* at 4664.

the allocations between regulated and nonregulated activities. Incumbent local exchange carriers subject to the cost allocation manual filing requirements must file changes to their manuals whenever the cost apportionment table is changed,[34] 60 days before that change takes effect.[35] A decision by an incumbent local exchange carrier to offer video programming service on a nonregulated basis will require a change to its cost apportionment tables.

IV. PROBLEMS WITH EXISTING PART 64 ALLOCATION METHODOLOGIES

16. Incumbent local exchange carriers' networks incur costs in providing two broad categories of facilities: dedicated and shared. Dedicated facilities are those used by a single type of service, *e.g.*, regulated telephony service. Shared facilities are used by more than one type of service, *e.g.*, regulated telephony and nonregulated offerings. The incremental cost of a service in a multi-service network is the difference between the cost of the facilities required for a complete system and the cost of the facilities in a system that does not provide that service. To the extent that the incremental costs of all services do not exhaust the total cost of the system, there are common costs that must be allocated on some basis.[36]

17. Part 64 identifies classes of costs based on a hierarchy of accounting-based, cost-allocation methodologies that attempt to emulate the manner in which costs are incurred. This hierarchy includes: direct assignment; attribution based on an allocator logically related to cost causation; and allocation based on a general allocator. These procedures are discussed in detail in section III, above. Dedicated costs must be directly assigned. The costs of shared facilities that have a traffic sensitive component are to be attributed on a cost-causative basis. Costs of shared facilities that do not have a traffic sensitive component are assigned by the general allocator.

18. Virtually all incumbent local exchange carriers' outside plant is dedicated and assigned to regulated activities by direct assignment. The majority of central office equipment is allocated to regulated activities, with only a small portion allocated to nonregulated activities. All shared switching costs are allocated between regulated and nonregulated activities based on the ratio of projected peak regulated and nonregulated usage over a three-year period, as prescribed by the Part 64 rules.[37] In the future, however, the outside plant that carries regulated

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[34] 47 C.F.R. § 64.903(b).

[35] *Id.* The period for review of the changes may be extended by the Bureau to 180 days.

[36] Strictly speaking, there may be costs that are common to groups of services that are not common to all services. We are concerned only with costs that are common to groups which include both regulated and nonregulated services.

[37] *See* 47 C.F.R. § 64.901(b)(4).

voice-grade communications might also, for example, be used to transmit video programming service for a carrier's open video or cable system or other nonregulated services. Thus, we recognize the need, and undertake in this proceeding, to address, for the first time, the allocation between activities regulated under Title II of the Communications Act and other "nonregulated" activities of substantial amounts of common costs for outside plant categories.[38]

19. The basic problem this proceeding must address is how to allocate costs of shared facilities that will be used jointly for regulated and nonregulated activities. For the nonregulated offerings contemplated in this proceeding, loop plant presents the greatest problem. Direct assignment is generally not available because loops capable of providing both regulated and nonregulated services generate common costs. Because loop plant is primarily traffic insensitive, the usage-based allocation process prescribed by our Part 64 rules does not result in cost-causative allocations.[39]

20. The rationale for allowing telephone companies to establish hybrid systems for both regulated and nonregulated activities is that the costs to telephony and video ratepayers (and other nonregulated services) should be less for services provided over the hybrid system than the costs of those services provided over stand-alone systems. In economic terms, the hybrid system offers economies of scope. Ideally, our cost allocation process would assign all regulated costs to regulated activities and all nonregulated costs to nonregulated activities. We seek to establish bounds on cost assignment that could prevent misallocations (or over-allocation) of costs that are common to the regulated and nonregulated activities. An over-allocation of common costs to regulated activities would cause regulated ratepayers to bear more costs than they would had the shared use facilities not been built. Conversely, an over-allocation of common costs to nonregulated activities, could dissuade companies from entering nonregulated competitive markets, thus depriving regulated ratepayers of any benefit from the economies of scope using facilities to provide both services might have created.[40] Economists have addressed these issues by defining the terms incremental and stand-alone costs. Economists would say that in order to give incumbent local exchange carriers the proper incentives to build multi-service facilities, where such facilities are economically rational, cost allocated to each individual service or subset of services should be less than the stand-alone cost but greater than the incremental cost. Stand-alone costs represent the total cost of constructing facilities dedicated to a specific group of services, while incremental costs represents the additional cost that must be incurred

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[38] Operation of a cable system or open video system, while "nonregulated" is still subject to Title VI of the Communications Act. 1996 Act sec. 302, § 251(a)(3)-(4).

[39] This is discussed in Section V.b.1.b, *infra*.

[40] We note that under rate-of-return regulation, costs allocated to regulated activities become the basis for regulated prices. The link between allocated regulated costs and prices under price cap regulation is less direct. We discuss the effect on price caps in Section VI, *infra*.

in order to provide a group of services where facilities are in place to provide other services.[41] These are the upper and lower bounds within which costs allocated to regulated and nonregulated services should fall.

21. In the following section, we discuss how we might address the cost allocation problems we have described. We first discuss the goals and purposes that should guide our efforts to establish necessary rules. We then discuss various mechanisms, some found in our current rules and others based on ideas outside of our current rules.

V. DISCUSSION

A. Goals and Purposes

22. The goal of the 1996 Act is "to provide for a pro-competitive, de-regulatory national policy framework designed to accelerate rapidly private sector deployment of advanced telecommunications and information technologies and services to all Americans by opening all telecommunications markets to competition. . . ."[42] Consequently, we recognize three basic goals for this proceeding. First, we seek to give effect to the provisions of the 1996 Act, and the underlying Congressional intent, that facilitate the development of competitive telecommunications service offerings. Second, we intend to give effect to provisions relating in particular to local exchange carrier entry into video distribution and programming services markets. Our third goal is to ensure that ratepayers pay telephone rates that are just and reasonable, as mandated by Section 201(b) of the Communications Act of 1934, as amended,[43]

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[41] The long-run incremental cost (LRIC) of a service is the theoretical foundation for efficient pricing of network services. We have defined LRIC as including "the full amount of incremental investment and expenses which would be incurred by reason of furnishing additional quantities of service, whether in a new or an existing service category." We added that in estimating LRIC, one "determine[s] prospectively the effect on total costs, including the effect on common costs, . . . of adding units of service." American Telephone & Telegraph Co., 55 FCC 2d 224, 231 n. 18 (1976) (citing American Telephone & Telegraph Co., 18 FCC 2d 761, 766 (1969)). Economists generally agree that prices based on LRIC reflect the true economic cost of a service and give appropriate signals to produces and consumers and ensure efficient entry and utilization of the telecommunications infrastructure. *See generally* Alfred E. Kahn, *The Economics of Regulation: Principles and Institutions* at 85 (1970).

[42] *Joint Explanatory Statement, Conference Report* at 113. The 1996 Act defines "advanced telecommunications capability" as "high-speed, switched, broadband telecommunications capability that enables users to originate and receive high-quality voice, data, graphics, and video telecommunications using any technology." 1996 Act at § 706(c)(1).

[43] 47 U.S.C. § 201(b).

and that are just, reasonable and affordable, as mandated by Section 254(b)(1) of the 1996 Act.[44] We also seek to ensure, as mandated under Section 254(k) of the 1996 Act,[45] that incumbent local exchange carriers do "not use services that are not competitive to subsidize services that are subject to competition."[46] Much of the network facilities incumbent local exchange carriers will use to provide nonregulated services, including video programming services may also be used to provide telephone services that we regulate pursuant to Title II of the Communications Act. To ensure that telephone subscribers are not forced to pay for the nonregulated offerings of the incumbent local exchange carriers, including video programming services, we address specific issues concerning the allocation of joint and common costs.

23. Our cost allocation proceeding is not intended to protect competitors in video service or other competitive markets. Consequently, our rules will intentionally allocate a significant part of common costs to nonregulated services. This is appropriate because we believe that telephone ratepayers are entitled to at least some of the benefit of the economy of scope between telephony and competitive services. Additionally, because cost allocation is inevitably imperfect, a policy of allocating all common costs to telephony would pose a significant risk that telephone ratepayers would pay more than stand-alone costs, and would thus be cross-subsidizing the incumbent local exchange carriers' competitive operations in violation of the Act.

24. We seek to establish a system of cost allocation principles that inhibits carriers from imposing on ratepayers the costs and risks of competitive, nonregulated ventures, including nonregulated video service ventures. We believe that such a system of cost allocation principles must balance: administrative simplicity; adaptability to evolving technologies; uniform application among incumbent local exchange carriers, in particular those that must file their cost allocation manuals with the Commission; and consistency with economic principles of cost causation.

25. Administrative simplicity should result in clarity of our rules so that carriers can quickly and accurately implement these procedures in their cost allocation manuals. Administrative simplicity would facilitate review of the revised manuals so that services can be offered without unnecessary delays. If allocation methods are too complex, they become costly and burdensome for companies to implement and for regulators to determine whether carriers are in compliance with such rules. Adaptability of the rules to technologies promotes viable competitive offerings. If the rules are not neutral with respect to the various alternative technologies available for providing a broad class of services, our cost allocation rules may inadvertently create an uneconomic incentive for carriers to use a technology other than the most efficient technology. The lack of such neutrality may also raise administrative costs by requiring

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44 1996 Act sec. 101(a), § 254(b)(1).

45 1996 Act sec. 101(a), § 254(k).

46 *Id.*

an unnecessary proliferation of rules and frequent revisions as new technologies develop. Uniformity in the application of our rules brings the certainty and fairness that promote the carriers' ability to compete effectively. This uniform interpretation and application of rules among a large group of carriers reduces administrative costs carriers might otherwise incur when they seek clarifications of rules and assists regulatory efforts to enforce those rules. Finally, consistency with economic principles of cost-causation is the most direct means of assuring that telephone ratepayers do not bear the costs and risks of competitive, nonregulated activities.

26. We seek comments on these goals and purposes. We also invite parties to suggest any additional goals that should be considered in this proceeding. In particular, we seek comment on how we can ensure that telephone ratepayers are protected by our processes for allocating costs between regulated and nonregulated activities generally and regulated and video programming services in particular.

B. Cost Pools and Allocation Methods

27. We tentatively conclude that we should prescribe specific cost pools and allocation factors in this proceeding for allocating video programming and other nonregulated service costs. Specific cost pools and allocation factors will produce certainty and uniform treatment of costs by incumbent local exchange carriers. Uniformity will reduce administrative burdens on both carriers and those reviewing carrier information. Uniform allocation methods will also foster competition in local exchange markets by allowing direct comparisons of cost allocations among incumbent local exchange carriers and helping highlight anomalies that may signal competitively harmful cost misallocations. We invite comment on this tentative conclusion. We also seek comment on whether this proceeding should prescribe specific rules for the allocation of video programming service costs or whether general guidelines could ensure realization of the goals identified in Section V.A above. Commenters should discuss the advantages and disadvantages of both approaches. While video may be the first significant nonregulated activity, it may not be the only one. We therefore seek comment on how we should treat the costs of providing other nonregulated services *vis a vis* cost pools and allocation factors.

1. Loop Plant

a. Direct assignment

28. Direct assignment is most easily accomplished when accounting or operating records demonstrate that particular facilities or resources are dedicated to regulated or nonregulated activities. We seek comment on the extent to which direct assignment can be used to allocate the costs of loop plant used for services subject to regulation under Title II and video programming and other competitive services between regulated and nonregulated activities.

29. One important issue is whether the developing changes in telecommunications technology make direct assignment impractical because either all or the vast majority of loop plant that would be used for video, high-capacity or otherwise competitive services would also

be used for regulated activities. Currently loop plant can be directly assigned to regulated activities because the deployed loops are used exclusively to provide regulated incumbent local exchange carrier services. Newer technologies, however, permit a single loop to be used for a mix of regulated and nonregulated services including the video programming services that the 1996 Act now permits incumbent local exchange carriers to offer. A loop facility providing video programming service, for example, may also provide voice-grade telephone service. We invite comment on which loop costs, if any, incurred in the provision of open video systems and other competitive services can be directly assigned to nonregulated activities.

b. Allocations based on usage measurements

30. Where direct assignment of specific costs of loop plant to regulated or nonregulated activities is not possible, our rules would require that those costs be allocated based on "the relative regulated and nonregulated use during the calendar year when nonregulated use is greatest in comparison to regulated use during a forecasted three-year period."[47] This cost allocation method has been applied to switching costs, which have been deemed traffic sensitive.[48] For loop plant, usage-based methods would require the allocation of non-traffic sensitive costs on a traffic sensitive basis. As discussed previously, the usage characteristics of video programming, and possibly other high-capacity competitive offerings, may differ significantly from those of voice-grade services. For example, where video programming services essentially constitute one-way communications, voice-grade services predominantly two-way. One-way video transmissions, such as motion pictures, may continue for several hours while two-way, voice-grade communications are much shorter on average. Furthermore, video transmission speeds (i.e., bits per second), and other high-capacity services, will dramatically exceed those of voice transmissions. Thus, given an equal number of two-way voice-grade and one-way video communications over loop plant, the video transmissions, and possibly other high-capacity offerings, will account for the majority of minutes of use, and even higher percentages of the information transmitted.

31. The use of loop plant by video programming services and voice-grade services also differs in another respect. The local exchange network carries numerous two-way, voice-grade communications, each unique, between the central office and a large number of widely dispersed subscribers. Voice-grade circuits typically leave the central office in cables transmitting numerous circuits that then branch into cables transmitting fewer and fewer circuits as they approach subscriber locations. Circuits transmitting video programming facilities, however, may transmit the same signal over a wide area, using a single video programming service circuit, similar to cable television facilities, to carry the same collection of video signals to each customer. Under this scenario, compared to voice-grade facilities, video programming

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[47] 47 C.F.R. § 64.901(b)(4).

[48] Technology is causing us to reexamine the assumption that switching costs are traffic sensitive. *See* Section V.B.2. *infra*.

service facilities would require much less circuit capacity near the central office, but much more circuit capacity near subscriber locations.

32. With respect to circuit equipment costs, commenters should address whether these costs are closely related to the relative use of the total circuit capacity created by that equipment. If so, a circuit having ten times the capacity of another circuit may incur ten times the cost. Alternatively, circuit equipment costs may be more closely tied to the number of times that a circuit is split by the circuit equipment than it is to the capacity of the individual circuits created. This distinction may be important because an allocation factor based on the relative use of total circuit capacity would not yield results reflecting cost causation if costs are related to the number of circuits used, irrespective of the capacity of those circuits.

33. We therefore tentatively conclude that differences in the usage characteristics of video programming services (and other high-capacity services that may be subject to competition) and voice-grade services discussed above could cause prescribed factors that would be based on usage measurements to produce results inconsistent with the goals of the 1996 Act and our guidelines for Part 64 discussed in Section V.A, above, particularly those listed in paragraph 24. We invite comment on this tentative conclusion.

c. Allocation based on a ratio of directly assigned plant

34. To the extent that the costs incurred by video and other competitive services do not vary substantially with usage or cannot be fairly allocated based on usage factors, another potential method of allocating the costs of loop plant that supports both regulated and nonregulated activities would be to develop a ratio that reflects the extent to which associated loop plant is directly assigned to regulated or nonregulated activities and apply that ratio to loop plant categories of common costs. Thus, if 40 percent of the directly assigned loop costs are assigned to regulated activities, then 40 percent of the loop costs of associated facilities would be allocated to regulated activities and 60 percent to nonregulated activities. We seek comment on whether this is an appropriate method for allocating loop costs, and in particular, whether the amount of loop plant that would be directly assigned would be so small as to result in unreasonable allocation results or opportunities for manipulation.

d. Establishment of a cost allocation ceiling

35. Another alternative would be to establish a ceiling on total loop costs that incumbent local exchange carriers may allocate to regulated activities. For the video programming and other competitive services offered through hybrid systems, the economies of scope would be the difference between the cost of stand-alone telephone and stand-alone broadband facilities, and the cost of the hybrid facilities. We cannot know these amounts precisely. We do know, however, that if the provision of a hybrid system is an economically efficient business decision, it will include economies of scope. The provision of telephony under the hybrid system, therefore, should be less costly than under the current stand-alone telephony system. We seek comment on whether it would be reasonable to establish a ceiling based on

he costs of the current stand-alone telephone system, thus capping the amount of costs an incumbent local exchange carrier may assign to regulated activities.

36. We ask whether the costs for these hybrid systems could be recorded on an exchange-by-exchange basis. If so, one possible way to define the ceiling on the allocation to regulated activities would be not to allow the cost per loop allocated from that exchange to regulated activities to increase. If the hybrid system includes economies of scope, we ask whether we should expect the annual cost of telephone service in the exchange, in fact, to decrease. If so, we seek comment on whether we should define that ceiling, for price cap regulated companies, each year, by applying a modified price cap formula to total cost per loop; *i.e.*, adjust the past-year total cost per loop by adding the inflation factor and subtracting the company's productivity factor.[49] The cost per loop to which the ceiling would apply would include the capital and operating costs associated with the loop plant (*e.g.*, return on net investment, income taxes, depreciate expense, maintenance, and network administration and services) rather than the gross book value of the loop plant.

e. Cost allocations based on fixed factors

37. The Commission's rules for allocating costs between interstate and intrastate regulated services employ fixed (*i.e.*, flat) allocation factors for allocating loop costs between the federal and state jurisdictions.[50] The loop plant is considered to be non-traffic sensitive because the costs of a loop do not vary with the volume of traffic it carries. The United States Court of Appeals for the District of Columbia Circuit has held that, for jurisdictional separations purposes, a fixed factor for loop plant is a rational alternative to a usage-based allocator.[51]

38. Fixed factors generally have not been used in the Part 64 cost allocation process. As video programming services and other high-capacity services become more prevalent, however, the use of fixed factors for allocating costs between regulated and nonregulated activities would simplify the allocation process by eliminating the need to measure usage.

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[49] Past-year total loop cost times (1+(GDP-PI minus X)). "GDP-PI" is the Gross Domestic Product Price Index used in the price cap formula to represent the effect of inflation; "X" represents the productivity factor elected by the incumbent local exchange carrier. *See* fn. 66 *supra*.

[50] In addition, a fixed factor of 50 percent is prescribed for allocating certain billing expenses between the jurisdictions. 47 C.F.R. § 36.380(c). Further, the Commission's rules require interexchange carriers to allocate residual circuit equipment costs based on factors frozen at 1985 levels. 47 C.F.R. § 126(d)(3).

[51] *See Rural Telephone Coalition v. F.C.C.*, 838 F.2d 1307, 1312-13 (D.C. Cir. 1988).

39. We seek comment in particular on specific allocation factors, such as 50 percent[52] that would split the costs of loop plant equally between regulated and nonregulated activities or some other factor. For example, the cable television providers have proffered that 28 percent of common costs might be allocated to telephony.[53] A fixed factor has the advantage of simplicity, and would eliminate the need for usage projections and measurements as well as subsequent reallocations to adjust for inaccurate projections.

40. We tentatively conclude that we should prescribe a fixed factor for allocating loop plant common costs between regulated and nonregulated activities. We reach this tentative conclusion because it appears that usage-based allocations for loop plant would preclude our achieving the best possible balance of goals and objectives discussed in Section V.A of this Notice.

41. A fixed factor approach for non-traffic sensitive loop plant presumes that a cost-causative allocation is not possible. When a cost-causative method is not available, the allocation must be based on other considerations such as demand or public policy considerations. Demand for telephone service is at present highly inelastic. Thus, without either regulatory intervention or workable competition, incumbent local exchange carriers have the ability to shift to telephone ratepayers a large portion of the cost of facilities used for both regulated and nonregulated activities. Such a result is contrary to the 1996 Act's requirement that ratepayers of regulated service not bear the costs or risks of competitive ventures and, therefore, would be an unacceptable result. For this reason we tentatively conclude that relative demand cannot form the basis for allocating common loop costs between regulated and nonregulated services.

42. Concerning our other goals described in Section V.A, a fixed factor would be simpler to apply and to audit than a usage-based approach. Fixed factors can be applied uniformly among carriers. We invite comment on these tentative conclusions. Proponents of fixed allocation factors should address the basis for determining the factors. Parties should address the legal authority and support for the derivation of the factor they propose.

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[52] *See e.g.* "Testimony of David F. Clark and Wayne R. Davis on behalf of The Southern New England Telephone Company," Application of SNET Personal Vision, Inc. for a Certificate of Public Convenience and Necessity to Operate a Community Antenna Television System, State of Connecticut Department of Public Utility Control, Docket No. 96-01, at 9 (Jan. 25, 1996), submitted with Southern New England Telephone Company's "Application Under Sec. 214 for Permission to Construct Telecommunications Facilities," (filed with the Com. Car. Bur. January 25, 1996), discussing a fixed allocation factor of 50 percent.

[53] Petition to Deny Pacific Bell's Section 214 Video Dialtone Applications of the California Cable Television Association, File Nos. W-P-C 6913 - 16, at 15 (filed Feb. 9, 1994).

2. **Switching Plant**

a. Current method of allocating switching plant costs

43. Today, most traffic switched at incumbent local exchange carriers' central offices involves regulated service. A portion, however, of the switching costs is allocated to nonregulated activities. Based in part on the assumption that switching costs are predominantly traffic sensitive, incumbent local exchange carriers must allocate switching costs between regulated and nonregulated activities based on the projected peak relative regulated and nonregulated usage over a three-year period. Under this method, the allocation reflects the allocation of switching plant that the carrier anticipates will be used during the three-year period.

b. Issues of changing technologies and discussion

44. We invite comment on whether we should continue to require incumbent local exchange carriers to allocate switching costs between regulated and nonregulated activities based on relative usage. More specifically, we ask whether or to what degree the duration of a call is, or will continue to be a valid usage measurement. Traditional analog and digital switches set up a circuit for each call. The circuit is maintained for the duration of the call, making part of the switch unavailable for other transmissions during that period. The operation of newer technologies, such as packet switching used to provide frame relay services,[54] and related services offering different capacities on demand, like asynchronous transfer mode (ATM),[55] differ substantially from the more traditional technologies used to transmit information. Packet

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[54] Packet switching divides data to be sent into individual packets, each with a unique identification and destination address. Each packet may arrive at the destination by a different route and may arrive in a different order from the order in which the packets were initially sent. The identification allows the data to be reassembled in its proper sequence. "Frame relay" is a form of packet switching.

[55] ATM is a flexible digital transmission method that allows different kinds of services to be offered in one network. It accomplishes this by putting the digitized voice, data or video signal into standard, fixed-length packets of bytes, called cells. Cells are assembled from the bit stream of the source call or service. In the network, these cells may be intermixed with cells from other services. Cells receive their routing instructions at ATM switching points. At their destination, the cells for each service are sorted, collected and disassembled into a bit stream appropriate to each service. Each cell moves through the network independent of other cells, even those of the same call. Cells for a given call, however, are routed over the same path. There are, however, no assigned time slots, as there are in synchronous packet switching systems; hence the name *asynchronous* transfer mode. BOC Notes on the LEC Networks -- SR-TSV-002275, Section 7.10 (April, 1994) (Prepared and published by Bellcore).

switches, including frame relay switches and ATMs, do not dedicate a circuit to each communication throughout its duration. An important issue, thus, may be whether the duration of the call is a reasonable basis for allocating the costs of packet switches between regulated and nonregulated activities. We invite interested parties to discuss that issue in view of our goals and purposes. We ask commenters to also discuss whether specific usage-based allocations should be used to separate the switch costs allocated to regulated and nonregulated activities. Commenters endorsing relative use methodologies, *e.g.*, relative number of packets routed during peak periods, should explain the mechanics of usage measurements they recommend and how we might evaluate the accuracy of carrier measurements. If switch costs are not traffic sensitive, economic principles of cost causation would appear to support a fixed allocator for switching costs. Commenters should assess the allocation methods they endorse, whether usage-based or a fixed allocation factor, in terms of the criteria discussed in paragraph 24 in Section V.A of this Notice.

3. Interoffice Transmission Facilities

a. Current method of allocating interoffice transmission facilities

45. Local exchange carrier interoffice trunk facilities are directly assigned to regulated activities. These facilities receive the same cost allocation treatment as loop plant, discussed above at Section V.B.1.b.

b. Discussion

46. Like loop plant, interoffice transmission facilities will be used to provide activities subject to regulation under Title II as well as nonregulated video programming and other competitive services. We invite comment on whether we should prescribe specific allocation methods to accommodate this change. We also ask whether our rules should distinguish between loops and interoffice trunks for Part 64 cost allocation purposes. In this regard, we ask whether our tentative conclusion to allocate loop costs based on a fixed factor is equally applicable to interoffice trunk facilities. We ask parties to discuss what allocation methods for interoffice trunks would be most consistent with the goals of the 1996 Act and the purposes discussed in Section V.A of this Notice.

C. Methods for Allocating Expenses

1. Network-related expenses

47. Under our existing rules, incumbent local exchange carriers allocate network-related expenses, other than maintenance expenses, in proportion to the allocation of the underlying network facilities. The allocation of network-related expenses associated with switching plant, for example, is based on a carrier's projected peak relative regulated and nonregulated usage over a three-year period. Expenses allocated according to these rules include items, such as depreciation, that track the carriers' investment in network plant. We tentatively

conclude that the allocation of these expenses should be based on the network plant allocation. We invite comment on this tentative conclusion.

2. Maintenance Expenses

48. Maintenance expenses, in contrast, are currently allocated based on usage.[56] Allocating these expenses based on a measure of relative regulated and nonregulated use appears to be a costly process and of questionable relevance because the majority of network plant investment is non-traffic sensitive. We tentatively conclude that, instead of our current method for allocating maintenance expenses based on measurements, we should use a fixed factor, and, in particular, the same factor we propose to use to allocate the maintained plant itself. Commenters should compare how well the current usage based factor and a fixed factor would meet the goals of the 1996 Act and this proceeding, and in particular, how well each meets the criteria set forth in paragraph 24, above.

3. Marketing Expenses

49. We require marketing expenses that cannot be directly assigned or directly or indirectly attributed to be allocated based on the allocation between regulated and nonregulated activities of those marketing costs that can be directly assigned or directly or indirectly attributed. We invite comment on whether we should retain this method to ensure that our allocation methods for video programming services and other nonregulated activities are consistent with cost causality and ensure that subscribers of regulated services are not forced to pay for the costs of competitive offerings. Commenters should assess their positions in terms of our goals as stated in Section V.A above, in particular, the criteria discussed in paragraph 24.

4. Overheads

50. Our rules require incumbent local exchange carriers to apportion overhead expenses between regulated and nonregulated activities, based on direct or indirect measures of cost causation.[57] Where direct or indirect attribution is not possible, our rules require the carriers to allocate overhead expenses, other than marketing expenses, based on a general allocator that is computed using the ratio of all expenses directly assigned or directly or indirectly attributed to regulated and nonregulated activities.[58] We invite comment on whether we should retain this approach and, in particular, on whether it is consistent with the goals and purposes described in Section V.A of this Notice

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[56] *See Joint Cost Order*, 2 FCC Rcd at 1320.

[57] 47 C.F.R. § 64.901.

[58] 47 C.F.R. § 64.901(b)(3)(iii).

D. Other General Allocation Issues

1. Allocation of Spare Facilities

51. Our rules require incumbent local exchange carriers to allocate network plant investment between regulated and nonregulated activities based on the peak "relative regulated and nonregulated usage" projected over a three-year period.[59] This method allocates spare (or reserve) capacity based on how the incumbent local exchange carrier projects that the deployed plant will be used during the three-year period. The projected use approach did not raise significant cost allocation problems in the past because only outside plant accounted for significant portions of spare facilities and virtually all outside plant usage has been used only for regulated activities. The potential introduction of video programming services and the growth of other high-capacity services that may be nonregulated, cause us to reexamine whether basing allocations for outside plant on peak relative regulated and nonregulated usage projected over a three-year period would be: consistent with economic principles of cost causation; administratively simple; adaptable to evolving technologies; and uniformly applied among carriers. We discuss and seek comment on this question for outside plant generally in Section V.B.1 and 3.

52. In the past, networks were designed primarily to carry voice-grade services over copper cables. As telecommunications networks evolve to include fiber cables deployed closer and closer to subscribers' premises and for inter-office trunks, however, the relative magnitude of spare facilities appears to be increasing. In some cases, spare capacity may be as great as the capacity of working facilities.[60] Because the allocation of spare capacity follows the allocation of deployed outside plant, this fiber, including the spare capacity, has been supported by regulated services. As a result of the 1996 Act, however, much of this spare capacity may be used exclusively for nonregulated activities.

53. We believe that Congress did not intend that telephone exchange service or exchange access subscribers pay rates designed to recover the costs of spare capacity that eventually will be used for video programming and other services that may be competitive.[61] This could occur, however, if, for example, spare facilities intended for competitive video programming services are allocated to residual categories that include spare facilities reserved for telephone services. We invite comment on how spare facility costs should be allocated between regulated and nonregulated activities, in particular, video programming service costs.

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[59] 47 C.F.R. § 64.901(b)(4).

[60] During 1991, 1992, 1993 and 1994, the LECs' total spare fiber, as a percent of total fiber deployment, was approximately 65 percent, 63 percent, 70 percent and 65 percent, respectively. FCC Report 43-08 (1991-94).

[61] 1996 Act sec. 101, § 254(k).

We also ask whether we should establish separate cost pools for the costs associated with spare facilities.

54. In raising these questions, we recognize that they may present just a small facet of a more general issue: to what extent will and should today's ratepayers pay for network improvements incumbent local exchange carriers make in anticipation of future competition in their core markets. We seek comment and information on which types of plant currently allocated to regulated activities might be used to provide competitive offerings. We also seek information on amounts and types of plant currently allocated to regulated activities that might be readily adaptable for use in providing competitive services.

2. Pole Attachment and Conduit

55. Section 224(g) of the 1996 Act requires utilities providing telecommunications or cable services to "impute to its costs of providing such services (and charge any affiliate, subsidiary, or associate company engaged in the provision of such services) an equal amount to the pole attachment rate for which such company would be liable under this section."[62] Pole attachment rates also include charges for conduits, ducts, and rights-of-way.[63] We invite comment on how this requirement should affect our rules for allocating outside plant costs between regulated and nonregulated activities.

56. One possible approach would be for the local exchange carrier to subtract the amounts it and its affiliates, subsidiaries, and associate companies engaged in the provision of telecommunications or cable services would be liable for pole attachments under Section 224 from the amounts recorded in USOA accounts before beginning the process of allocating those accounts between regulated and nonregulated activities. Alternatively, we could require carriers to assign all costs that our pole attachment formulas allocate to pole attachments to separate costs pools that would be created within each USOA account. These cost pools could then be allocated between regulated and nonregulated activities based on the relative number of pole attachments the carriers and their affiliates, subsidiaries, and associate companies use for regulated and nonregulated activities. A third method would be for the carrier to perform the imputation after allocating costs between regulated and nonregulated activities. Under this approach, any difference between the costs allocated to regulated and nonregulated activities in the Part 64 cost allocation process and the pole attachment rates chargeable under Section 224 could be allocated between regulated and nonregulated activities using an allocator reflecting the relative number of pole attachments the carrier uses to provide telecommunications and cable services.

[62] 1996 Act sec. 703, § 224(g).

[63] 47 U.S.C. § 224(a)(4).

57. We invite comment on whether each of these approaches would be consistent with the language of, and Congressional intent behind, Section 224(g). We ask commenters to address whether these approaches are consistent with our goals and purposes as stated in Section V.A, above. In particular, we ask commenters to discuss how well each of these alternatives meets the criteria set forth in paragraph 24 above. We also invite commenters to propose other alternatives that might better implement those goals and purposes.

VI. TREATMENT OF COST REALLOCATIONS UNDER PRICE CAP REGULATION

58. We rely upon price cap, rather than rate-of-return, regulation to assure that rates for the interstate services of the largest incumbent local exchange carriers, including the Bell Operating Companies, are reasonable. Under our system of price caps, most changes in a carrier's costs of providing regulated services are treated as "endogenous" and do not result in adjustments to the carrier's price cap indices. The Commission, however, has identified certain cost changes, triggered by administrative, legislative, or judicial action that are beyond the control of the carriers, that can trigger adjustments to those indices.[64] The Commission concluded that failing to recognize these cost changes by adjusting price cap indices would either unjustly punish or reward the carrier by leading to unreasonably high or unreasonably low rates.[65]

59. The Commission determined, however, that not all changes beyond the carrier's control should be treated exogenously. For example, a general change in tax rates is outside the carrier's control, but will be reflected in the inflation factor used to adjust price caps annually.[66] Exogenous treatment of a tax change would thus unfairly "double count" its impact. The Commission concluded that only changes that "uniquely or disproportionately affect [incumbent local exchange carriers]" would be considered for exogenous treatment.[67]

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[64] Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, 5, FCC Rcd 6786, 6807 (1990) (*LEC Price Cap Order*), Erratum, 5 FCC Rcd 7664 (Com. Car. Bur. 1990), *modified on recon.*, 6 FCC Rcd 2637 (1991) (*LEC Reconsideration Order*), *aff'd*, *National rural Telecom Ass'n v. FCC*, 988 F.2d 174 (D.C. Cir. 1993), citing Policy and Rules Concerning Rates for Dominant Carriers, CC Docket No. 87-313, *Notice of Proposed Rulemaking*, 2 FCC Rcd 5208 (1987); *Further Notice of Proposed Rulemaking*, 3 FCC Rcd 3195 (1988); *Report and Order and Second Further Notice of Proposed Rulemaking*, 4 FCC Rcd 2873 (1989) (*AT&T Price Cap Order*) 4 FCC Rcd 2873, 3187; *modified on recon.*, 6 FCC Rcd 665 (1990).

[65] *Id.*

[66] *Id.* at 6808. GNP-PI, the gross national product price index, was replaced by the gross domestic product price index (GDP-PI) as the inflation factor in the price cap formula.

[67] *Id.*

60. Our price cap rules specify that "[s]ubject to further order of the Commission . . . , exogenous cost changes . . . include those caused by . . . [t]he reallocation of investment from regulated to nonregulated activities pursuant to" our Part 64 cost allocation rules.[68] Under a strict reading of this rule, a presumption that cost reallocations due to changes in the Part 64 cost allocation process are exogenous would only apply to amounts reallocated "from regulated to nonregulated activities." We seek comment on this interpretation and whether all such reallocations to nonregulated activities that may result from the offering of video programming services or other nonregulated activities should trigger decreases in related price cap indices. We also seek comment with respect to each of the allocation methodologies discussed above on the effect of Part 64 exogenous changes on the incentives for price cap carriers to enter video and other competitive, nonregulated service markets.

61. Price cap carriers continue to report their earnings for monitoring and sharing. Price cap carriers subject to sharing obligations must reduce their price cap indices if earnings exceed specified benchmarks.[69] In their most recent annual tariff filings, however, all but four incumbent local exchange carriers subject to our price cap rules[70] elected the highest interim productivity factor we had prescribed, which exempts them from sharing obligations for the 1995-96 access year.[71] Under the current price cap rules, carriers may elect a different productivity factor each year. Accordingly, the price cap incumbent local exchange carriers may decide whether to participate in sharing on a year-to-year basis.

62. We seek comment on the need for Part 64 processes in our regulation of price cap carriers that are not subject to sharing obligations. We also seek comment on how the relationship of our cost allocation rules to price cap companies should influence the outcome of this proceeding. We note that the states have not uniformly adopted the same price cap model.

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[68] 47 C.F.R. § 61.45(d)(1)(v). *See also* 47 C.F.R. § 61.44(c)(4). Costs claimed as exogenous that appear to fit within this category are presumed exogenous. They must be shown, however, to comply with the underlying definition of exogenous costs -- that they are incurred by means beyond the control of the carrier and that they are not otherwise accounted for in the price cap formula.

[69] *See* 47 C.F.R. § 61.45(d)(2).

[70] The exceptions are Southern New England Telephone Company, Citizens Utilities Companies, US West Communications and a portion of GTE.

[71] In the *LEC Price Cap Performance Review*, the Commission adopted interim price cap rules establishing three productivity factors from which local exchange carriers could select -- 4.0 percent, 4.7 percent and 5.3 percent. No sharing obligation for the interim period is required of local exchange carriers that choose the highest factor. Price Cap Performance Review for Local Exchange Carriers, *First Report and Order*, 10 FCC Rcd 8961 (1995) (*LEC Price Cap Performance Review*).

We ask whether this should influence any conclusion we reach on the continuing need for Part 64 rules.

63. We also invite parties to comment on whether there are conditions under which these cost allocation rules will not be necessary. For example, parties should address whether some form of cost allocation should be required as long as services are offered that are not subject to competition. Parties should address the statutory and legal requirements placed on both the Commission and on companies to allocate costs between regulated and nonregulated activities.

VII. PROCEDURAL MATTERS

A. *Ex Parte*

64. This is a non-restricted notice and comment rulemaking proceeding. *Ex parte* presentations are permitted, except during the Sunshine Agenda period, provided they are disclosed as provided in the Commission's rules.[72]

B. Comment Dates

65. We invite comment on the issues set forth above. Interested commenters may file comments on or before May 28, 1996, and reply comments on or before June 7, 1996. To file formally in this proceeding, you must file an original and six copies of all comments, reply comments, and supporting comments. If you want each Commissioner to receive a personal copy of your comments, you must file an original plus eleven copies. You should send comments and reply comments to Office of the Secretary, Federal Communications Commission, Washington, D.C. 20554. A courtesy copy should also be sent to Ernestine Creech, Accounting and Audits Division, 2000 L Street, N.W., Washington, D.C. 20554. Commenters should also provide one copy of any documents filed in this proceeding to the Commission's copy contractor, International Transcription Service (ITS), 2100 M Street, N.W., Suite 140, Washington, D.C., 20037. Comments and reply comments will be available for inspection during regular business hours in the FCC Reference Center, Room 239, 1919 M Street, N.W., Washington, D.C. 20554. For further information contact Ernestine Creech at 202 418-0850.

66. In order to facilitate review of comments and reply comments, both by parties and by Commission staff, we require that comments be no longer than twenty-five (25) pages and reply comments be no longer than fifteen (15) pages. Comments and reply comments must include a short and concise summary of the substantive arguments raised in the pleading.[73]

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[72] *See generally* 47 C.F.R. §§ 1.1202, 1.1203, 1.1204(a).

[73] Comments and reply comments must also comply with Section 1.49 and all other applicable sections of the Commission's rules. *See* 47 C.F.R. § 1.49. We require,